AUBURN FOOTHILL FORUM
MEETING MEMO

To:	Auburn Brokers/Title Officers/Lenders
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Subject:	THOUGHTS ON TRANSFERS IN TROUBLED TIMES
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As brokers, agents and lenders try to service their residential and commercial market when conventional financing is unavailable, deals using creative financing methods are popping up. Some history and some warning.

ñWrapsò and ñsubject toò transactions because very popular in the late 1970s and early 1980s because of the high interest rates which made new financing extremely difficult to arrange. In this days, lenders were under certain circumstances ñstuckò with having their conventional loans defacto transferred from Seller to Buyer, and the balance of the equity carried back by the seller junior to the rights of the non-consenting lender. In such a case seller wanted a premium for the risk that his equity would be wiped out if the lender started foreclosure because of the unlawful transfer of the property, thus placing payment of sellerôs equity at risk. In the 1970-1980s scenario, the ñvalueò of the properties, continued to increase as a result of inflation, for the benefit of the private parties with the steel to see the deals through.

Today, there is little or no equity in such deals, and the underlying financing may already be in default. Where the existing defaulted or underwater loan remains on the property and the property is transferred to the buyer, such transfers contain multiple risks to both seller and buyer, and thence to the agent. The more obvious risks are that the underlying lender will foreclose wiping out buyersô possessory rights are fairly obvious and can be addressed with adequate disclosure. However, the rights of the seller to enforce collection of any remaining equity or future opportunities for recovery of principal, assuming that the buyer is able to make the payments, is problematic and should be carefully considered when you are trying to write up such a deal.

Besides the risk of the Buyer being foreclosed and Seller losing any ñequityò think about unenforceability due to usury laws. Usury is usually understood as the improper, high, collection of interest on a note, but that ñstreetò definition is too narrow.

Usury defined. A usurious transaction is a "loan or forbearance of money, goods or things in action" pursuant to which a "person, company, association or corporation" directly *or indirectly* takes or receives in "money, goods, or things in action, or in any other manner whatsoever, any greater sum or any greater value" than is allowed by law. A "person" or "association" includes a trust.

Four essential elements. There are four essential elements that must be proved in order to establish usury, as follows:

1. The transaction must be a loan or forbearance of the use of money;

2. The loan or forbearance must be made by a nonexempt lender and in a nonexempt transaction. Generally loans arranged by real estate brokers are defacto exempt;

3. The interest received by the lender must be in excess of the statutory maximum rate that is applicable to the transaction; and

4. The lender must have a willful intent to enter a usurious transaction.

Extension of a purchase money loan. Where the original transaction was exempt from the Usury Law because it was a purchase money note, the debt was not created by a loan. One might assume, however, that an extension or postponement of the maturity of such a note is a forbearance. The case law is clear that a built-in extension agreed to at the inception of the transaction is not a forbearance but is merely a continuation of the sale. However, an extension or modification of a purchase money note *also does not constitute a forbearance* but is merely a continuation of the credit sale. If the parties agree that the due date of the loan will be extended but the borrower will pay an interest rate in excess of the legal maximum during the period of the extension, the excessive interest charged during the extension of a purchase money loan does not become usurious. The Usury Law does not apply to the transaction even though the modification or extension is given to a successor of the original party liable on the note.

Case Example:

A seller received a secured all-inclusive purchase money note that wrapped around an existing purchase money note secured by a first deed of trust. The property was sold to an interim buyer who immediately resold the property to the current owner, who accepted title subject to the wraparound note held by the seller. A dispute arose regarding the amount due on the wraparound note, which the parties settled by restructuring the debt. The buyer paid a portion of the debt by cash and the balance by two secured notes. One note bore interest at 13% per annum and the other note bore interest at 10% per annum, but provided for the addition of $100,000 to the principal, which made the effective interest rate 17.5% per annum. At the time of the transaction the maximum interest rate permitted by the Usury Law was 10.5% per annum.

The Court held that the settlement transaction was not a loan or forbearance. The notes given in settlement of the dispute regarding the balance due on the purchase money note were the functional equivalent of a modification of an originally exempt credit sale, and such a modification is not subject to the Usury Law. There is no usury unless the transaction constitutes a loan or forbearance of money. In examining the substance of the transaction, the settlement notes given in exchange for the original purchase money note did not constitute a loan. Merely because a new debtor-creditor relationship was created between the seller and buyer does not necessarily mean that the transaction was a loan. A mere extension or modification of a note that is exempt from the Usury Law does not constitute a loan or forbearance. Since the original purchase money notes were exempt from the Usury Law, upon default the seller could have foreclosed or agreed to a modification or extension.

Comment:

This decision was in the context of a purchase money note, which is governed by the credit sale doctrine rather than the usury law.

Case Example:

The buyer paid a portion of the purchase price of real property with a secured purchase money note to the seller, which provided for 10% interest. When the note became due, the buyer requested an extension, but, since the prevailing rates had increased, the holder of the note agreed to the extension only if the interest rate were increased to 15%. The Usury Law only permitted a 14% rate. Neither party was aware of the Usury Law, and the note holder did not intend to receive more interest than was legal. The buyer paid the note and brought an action to recover the interest paid as usurious.

The court confirmed that a bona fide credit sale is not subject to usury. Therefore, the original purchase money transaction was not usurious. The court defined a forbearance as "an agreement to extend the time for payment of the obligation due (which is made) either *before* é [or] *after* the obligation's due date," and concluded that it would be unfair to apply the Usury Law to this transaction, referencing the proposition that "a debtor by voluntary act cannot render an otherwise valid transaction usurious." A creditor could wait for the buyer to default, foreclose on the property, and then resell the property to the buyer with a new purchase money note at the higher rate, at least where there was no prior agreement between the parties prior to the foreclosure. "If the parties could lawfully avoid the Usury Law indirectly by going through the foregoing convoluted process, there should be no reason why they should not be able to do so directly."

Problematic Areas:

- ✓ Where existing note is left in place such note is not protected by real estate broker arranging second. In such a case the two notes can be treated as blended and the seller/lender may be subject to statutory penalties.

- ✓ Where instead of a note prepared as part of the transaction, instead the lender agrees to forebear enforcement. [1]

[1] These examples are not intended to be exhaustive, but give the reader recent examples of cases where depending on the facts such transactions were held to be usurious. Your specific creative financing transaction must be individually reviewed with your broker, and if necessary counsel.

A **forbearance** is the extension of additional time for the repayment of an obligation or an agreement not to enforce a claim on its due date, or releasing and extending the borrower's obligation for repayment. An agreement made before the debt is due may be a forbearance. The forbearance may be by "an agreement to extend the time for payment of the obligation due (which is made) either *before* é [or] *after* the obligation's due date."

An agreement to settle a dispute pending a foreclosure by an extension of a note for an additional consideration is not a forbearance, at least where the original debt was exempt. When the borrower is personally liable for the debt, a release of personal liability for additional consideration is a forbearance.

Case Example:

A subdivider was in financial difficulty, and numerous mechanic's lien claimants were threatening foreclosure. In order to preserve the equity value in the property, the creditors and the subdivider agreed that the entire subdivision would be conveyed to a creditor's committee; the lots would be sold and the debts paid, and any surplus proceeds would be paid to the subdivider. However, the subdivider would only enter into the arrangement if the creditors agreed to release him from personal liability. Therefore, in consideration for the agreement of the creditors to delay foreclosure and to accept the distributions from the lot sales, and for the release of the subdivider's personal liability, the subdivider agreed that, after the debts were paid, the creditors would receive an additional twenty lots and the proceeds from the sale of these lots before any surplus sales proceeds were distributed to the subdivider.

The court held that the transaction was usurious, because at the time of the agreement the twenty lots had a readily ascertainable fair market value, and even though the date of sale and the amount that would be received from their sale was speculative, the value of the lots received was a "bonus" and interest. In addition, the agreement to defer foreclosure of the mechanics' liens, and the agreement to release the subdivider from personal liability, each constituted a forbearance within the Usury Law.

Late charges. A charge or penalty imposed when an installment is not paid when due is *not subject t*o the Usury Law. The provision for a late charge is not a forbearance, since the creditor is not agreeing to delay payment.

Extension or forbearance of nonusurious loan. A forbearance is a separate element in a usurious transaction. Although the original loan is not usurious, any extension or forbearance of the loan may be subject to the usury limitations, unless it is exempt by some other provision of the Usury Law.

Effect of additional consideration for renewal on original nonusurious loan. An original loan may be made for a rate which is within the maximum limitations of the Usury Law, but when the creditor agrees to extend the period of repayment of the debt for additional consideration, the new consideration, when added to the interest return provided in the original contract and calculated over the full term of the loan as extended, may result in a total interest obligation of the borrower in excess of the maximum usury limitations. For example, if the creditor increases the interest rate or requires payment of a bonus for the extension of the loan, the extension may be usurious even though the original loan was not usurious. Similarly, where a creditor exacts a bonus for not foreclosing after the debtor is in default, the bonus is consideration for a forbearance and subject to the Usury Law.

Method of calculating interest on renewal of a nonusurious loan. When the original loan is not usurious by its terms at its inception, but an additional charge or bonus is imposed for a renewal or forbearance, when calculating whether the additional charge is usurious, the percentage of interest charged is determined by taking the additional consideration charged for the forbearance, including any other interest received by the terms of the loan, and dividing it by the *entire unpaid balance* of the loan.

Case Example:

A portion of the purchase price for a parcel of property was paid by a purchase-money note in the principal sum of $1,420,000, bearing interest at 6% per annum. Several years later, when the balance due was $1,020,000, the note provided for a principal payment of $510,000. When the buyer was unable to make the payment, the parties agreed that the buyer would pay all interest due, plus a principal payment of $100,000, and that the balance of $410,000 would be paid 5 ½ months later. As consideration for this extension, the interest was increased to 9% on the entire unpaid balance of $920,000. The buyer argued that the forbearance was only for $410,000, but the charge was additional interest on $920,000 and this amounted to 18.7%. The court held, however, that the charge for the forbearance should be calculated by taking the charge for the extension and applying the additional charge to the entire unpaid balance and, therefore, the forbearance was not usurious.

Effect of a usurious renewal of a nonusurious loan. When the charge or bonus imposed for a renewal or forbearance of a nonusurious loan exceeds the legal maximum interest rate, the forbearance or renewal is considered to be a separate transaction. The original loan can be enforced according to its terms, and the creditor can collect the nonusurious contract rate of interest and the original principal of the debt. However, the creditor is subject to the usury penalties for the usurious interest charged for the renewal or forbearance.

Case Example:

A creditor recovered a judgment on a nonusurious loan and, at the debtor's request, purchased the first lien by assignment and received a deed to the debtor's home as additional security, pursuant to an agreement that the creditor would delay enforcement of each of the debts. However, the parties agreed that any additional advances by the creditor would bear interest at the rate of 2% per month. Although the forbearance agreement was clearly usurious, the Court held that the creditor could enforce the original debts and collect the legal interest by their provisions. In other words, the Court did not treat the entire transaction as usurious, but held merely that the interest on the forbearance agreement was not collectible.

Case Example:

A loan for $2,500 provided for interest at eight percent per annum for a term of six months. Thereafter there were successive renewals at six-month intervals, and the lender charged an additional $125 for each renewal. The court held that the renewal consideration was excessive and rendered the entire transaction usurious *from the date of the first renewal.*

Case Example:

A note bearing interest at 10% per annum was in default, and the lender had commenced foreclosure proceedings. He agreed to continue the foreclosure sale for $500, which amounted to an annual rate of 11.88% on the debt of $50,560. The court held that this forbearance was usurious, but a second continuance for a charge of $100 was found to be nonusurious.